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Federal Communications Commission
Office of the Secretary

November 10, 1992

EX PARTE

Ms. Donna R. Searcy
Secretary
Federal Communications Commission
Stop Code 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

RE: CC Docket No. 92-101

Dear Ms. Searcy:

Today Bill Taylor of National Economic Research Associates, Inc. (NERA), and Bill Adler and Sherry Herauf from Pacific Telesis Group, met separately with the following FCC staff to review the Pacific Companies' position in the above referenced proceeding regarding the adoption of SFAS 106 for ratemaking and the exogenous treatment under Price Caps of related costs:

- Linda Oliver
- Charla Rath
- Kathleen Abernathy, Lauren Belvin, and Madelon Kuchera
- Cheryl Tritt, Chief of the Common Carrier Bureau, and members of her staff.

The attached written material was distributed and discussed.

In accordance with Section 1.1206(a)(1) of the Commission's rules, enclosed is an additional copy of this letter with the appropriate attachment. Please include the attached material in the above referenced proceeding.

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Acknowledgement and date of receipt of this transmittal are requested. A duplicate letter is attached for this purpose.

Please contact me if you have any questions concerning this matter.

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Federal Communications Commission
Office of the Secretary

Respectfully submitted,

Sherry Herauf

Attachment
cc: Kathleen Abernathy
Lauren Belvin
Madelon Kuchera
Linda Oliver
Charla Rath
Cheryl Tritt
Dan Grosh
Kathy Levitz
Greg Vogt

SFAS 106

Employers Accounting for Postretirement
Benefits Other Than Pensions

Impact on Pacific Bell

Pacific Bell
November 10, 1992

SFAS 106

Employers Accounting for Postretirement
Benefits Other Than Pensions

Impact on Pacific Bell

I. What is SFAS 106?

II. Impact of Change Should Receive Exogenous Treatment in The Price Cap Formula

III. Economic Effects of SFAS 106 on FCC Price Cap Regulated Firms

IV. Conclusion

I. WHAT IS SFAS 106?

- Financial Accounting Standards Board (FASB) issued a new accounting standard (SFAS 106) in December 1990 which mandates accrual accounting for postretirement benefits other than pensions (OPEBs)

- OPEBs include all retirement benefits other than retirement income.

  Pacific Bell provides:

  - Medical benefits (health insurance)
  - Dental benefits
  - Life insurance

- Prior to SFAS 106, employers generally accounted for OPEBs on a pay-as-you-go basis.

- FCC authorized the adoption of SFAS 106 in December 1991, effective January 1, 1993.

- Impact on financial results is an increase in expenses to reflect

  1) Accrual for expenses expected in future on behalf of current employees

  2) A catch-up accrual to reflect previously unrecognized OPEB liabilities on behalf of current and retired employees

II. IMPACT OF CHANGE SHOULD RECEIVE EXOGENOUS TREATMENT IN PRICE CAP FORMULA

- Adoption of accounting change is beyond the control of the carriers

- Costs of accounting change should be recoverable to the extent they are not already reflected in the GNP-PI

- Pacific Bell impact of the exogenous change is $27 million

- Costs reflect one-time incremental effects of implementation of SFAS 106.

III. THE ECONOMIC EFFECTS OF SFAS 106 ON FCC PRICE CAP REGULATED FIRMS

A. Economic Effects of a Change from Cash to Accrual Accounting

B. Adoption of Accrual Accounting for Ratemaking Purposes

C. Exogeneity and Control of Costs

D. Double-Counting

III. THE ECONOMIC EFFECTS OF SFAS 106 ON FCC PRICE CAP REGULATED FIRMS

A. ECONOMIC EFFECTS OF A CHANGE FROM CASH TO ACCRUAL ACCOUNTING

1. Accrual accounting for OPEBs recognizes economic costs of OPEBs; cash accounting does not. Therefore,

    - Prices in regulated markets are based on accounting costs using cash accounting for OPEBs.

    - Prices in unregulated markets already reflect the economic costs of OPEBs

    - Therefore, adoption of SFAS 106 will affect prices in regulated markets but not in unregulated markets.

III. THE ECONOMIC EFFECTS OF SFAS 106 ON FCC PRICE CAP REGULATED FIRMS

A. ECONOMIC EFFECTS OF A CHANGE FROM CASH TO ACCRUAL ACCOUNTING

2. Prices for regulated and unregulated firms must both be based on the same view of economic costs.
   - Intergenerational equity.
   - Competitive equity.

Therefore,

3. Price-cap regulated firms should increase prices by the one-time difference in expense between cash accounting and accrual accounting for OPEBs.
   - Places price-cap firms where they would have been if price caps had begun under accrual accounting for OPEBs
   - Gives price-cap firms same incentive to control medical costs and OPEB benefit levels as they have to control wages.

B. ADOPTION OF ACCRUAL ACCOUNTING FOR RATEMAKING PURPOSES

1. Intergenerational equity: the matching principle

   - Each generation should pay at least the economic costs it causes to be incurred; otherwise, consumers are sent incorrect signals regarding consumption.

   - Economic costs incurred are measured by accrual accounting expenses, not cash accounting expenses.

2. Competitive equity

   - Incumbent firms in telecommunications markets should set prices that recover at least incremental economic costs; otherwise, potential entrants are sent incorrect signals regarding their ability to enter profitably.

   - Competitive trends in telecommunications markets make it impossible for a regulated firm under cash accounting to recover its unfunded liability in later years.

C. EXOGENEITY AND CONTROL OF COSTS

1. To warrant exogenous treatment, a change in costs must be beyond the control of the firm.

2. We must distinguish costs that are beyond the control of the firm from cost changes that are beyond the control of the firm.

   - LECs control level of OPEB benefits to the same extent they control current and future wages.

   - LECs have no control over the decision of the FASB and the FCC to adopt accrual accounting for OPEBs.

   - Therefore, exogenous treatment is appropriate for the one-time effects of the adoption of accrual accounting for OPEBs, not for on-going changes in the level of OPEB benefits.

C. EXOGENEITY AND CONTROL OF COSTS

3. An example:

- Everyone agrees that a change in separations rules is an appropriate exogenous adjustment.

- For a separations rule change, the LEC is compensated for the effect on costs of the change in the separations rules not for increases or decreases in costs subject to separations.

- The LEC has control over the level of interstate costs, yet the change in costs due to the rule change is still an appropriate exogenous adjustment.

III. THE ECONOMIC EFFECTS OF SFAS 106 ON FCC PRICE CAP REGULATED FIRMS

D. DOUBLE-COUNTING WITH GNP-PI

1. The Problem:

   The price cap increases each year by GNP-PI - X $\pm$ Z. If adoption of SFAS 106 increases inflation (GNP-PI) and the change in LEC costs is given by Z, the LECs would double-recover the change in their costs.

2. The Solution:

   Measure the effect of the adoption of SFAS 106 on output prices in the economy.

   Reduce Z by the percentage in GNP-PI due to implementation of SFAS 106.

III. THE ECONOMIC EFFECTS OF SFAS 106 ON FCC PRICE CAP REGULATED FIRMS

D. DOUBLE-COUNTING WITH GNP-PI

3. Regulated and cost-plus firms will increase prices in response to SFAS 106 by the difference between accrual and cash accounting for OPEBs.

   - The annual change in U.S. accounting expenses from adoption of SFAS 106 is about 1.1 percent; $69 billion in 1993 compared with estimated GNP of $6,260 billion.

   - The regulated and cost-plus sector is (conservatively) estimated to be 10.49 percent of GNP.

   - So we assume 10.49 percent of U.S. GNP will experience a 1.1 percent price increase. Note that this assumption is conservative because it implies that <u>all</u> purchasers of the output of the regulated firms will pass through the higher prices in their output prices.

4. Unregulated firms will make no change in prices in response to SFAS 106 because their prices already reflect economic costs.

5. Therefore, the effect of SFAS 106 on GNP-PI is less than 0.12 percent (= 1.1% x 10.49%).

IV. CONCLUSION

- Pacific Bell rates reflecting exogenous treatment of incremental impact of adoption of SFAS 106 are just and reasonable.

- Rates reflect one-time exogenous adjustment.

- Calculation of exogenous amount excluded effects on GNP-PI to eliminate double-counting.

Pacific Bell Impact of SFAS 106

Interstate Impact of SFAS 106
Dollars in Millions

		1993
1)	SFAS 106 Accrual	$59.5
2)	OPEB Cost Recovery -- Current Methodology	30.1
3)	SFAS 106 Incremental Rate Base Impact	0.6
4)	Net Increase (L1 - L2 - L3)	28.8
5)	GNP-PI Effect (6.25%* x L4)	1.8
6)	Total Z Factor Adjustment (L4 - L5)#	27.0
7)	Billing and Collection Allocation	1.6
8)	Net Price Cap Increase (L6 - L7)	25.4
9)	Amount Included In Proposed Rates	$20.0

* Per NERA Study, Page 32
\# Per Transmittal Letter No. 1579, Workpaper II